The Good Bank, an alternative solution to the banking crisis

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Last week I read *Atlas Shrugged* by Ayn Rand and I started to wonder: "Who is trying to stop the motor of the world?" The main culprit seems to be the federal government, which is behaving the same way as Rand's fictional "looters." And, since America's economy today is eerily similar to Rand's depiction of a society in decline, this brings up yet another question: Who and where is the modern-day "John Galt?"

If he does exist, maybe he can tell us how to fix the current fiscal mess. This question is being debated ad nauseam and yet nobody has come up with a plausible answer. So here is some outside-the-box thinking to help save the institution that made this country great: free market capitalism.

The "bad bank" is one idea being proposed, where an entity will be created to buy up all the toxic assets from the failing financial institutions. But where will all those toxic assets go? Do they just disappear into thin air? No, they would stay on a balance sheet until that institution calls them what they are – worthless.

As I ponder the questionable validity of the "bad bank" idea, it also leads me to wonder how the government expects to eliminate moral hazard without letting failing businesses go bankrupt.

Prior to July of 2007, most institutions were taking high risks with their mortgage related investments, predicting that, if they were to face bankruptcy, the government would bail them out. This assumption has proven to be correct. Due to the government's unwillingness to allow large banks to collapse, our financial institutions will continue to make the same mistakes time and time again. In other words, there's no longer any risk in "risky" investments. The government may honestly believe that bailouts are good for the economy, but they are only compounding the problem and making the recession worse.

Here is a proposed solution for this problem: A hybrid of free market capitalism and temporary government intervention. The first part of the remedy is, let the poorly run institutions fail. The most *efficient* economy is one where a large number of companies compete against one another. In an *inefficient* economy, fewer businesses compete. So by allowing mismanaged or incompetent banks to declare bankruptcy, we are also allowing entrepreneurial and properly managed financial institutions to spring up in their place. More importantly, this approach eliminates moral hazard and proves that risk is a very real thing that should not be ignored.

The problem with the "cold turkey" approach is that we would have to go through a significant amount of *hardship* to correct the current course we are on. It would also cause many efficient businesses to close up shop as the demand for their goods and services diminishes. Although this approach would ultimately correct the flaws in our system, no politician who values his job would casually ask the public to accept such draconian measures.

How about this: Instead of creating a "bad bank" to buy up all the toxic assets, create a "good bank," which would receive the taxpayer's dollars and have a mandate to lend the money only to qualified borrowers.

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If we take the banking formula of lending $10 for each $1 in deposits, we could appropriate $100 billion of the taxpayers' money that is allocated for any one of the insolvent financial institutions - which will most likely fail anyway - and create a "good bank." This $100 billion could lend $1 trillion to qualified borrowers.

Is this nationalization? Yes, but isn't this what the government is doing right now anyway?

Fortunately, there is a solution for that. The "good bank" will be mandated to lend out to borrowers at a rate of, for example, 1 percent over the market rate. This makes sense because if people cannot get a loan or line of credit from anywhere else, they will still be able to get one from this "good bank," as long as they fit the criteria. This approach solves two problems: First, it frees up the capital for the borrowers who normally can get a loan or line of credit. Second, it actually ensures that the institution will not become a perpetual entity that public policy could screw up later at the whim of an overzealous politician.

Mandating 1 percent over market rates allows this institution to naturally dissipate when the free markets return**. It will remain deliberately uncompetitive**. This way, the taxpayers get their money back with a decent return, and the bank will not become a permanent liability down the road.

What about the large financial institutions we are trying to save for the benefit of our economy and society? Obviously, this new entity would circumvent the need for these institutions.

In other words, this approach would take business away from the failed institutions and allow efficient ones to run as they should. The "bad banks" are not lending the money given to them by the taxpayers anyway, so why should we enable them?

Once the failed financial institutions "fix" their problems, they would be able to operate again and take business back through competitive pricing. If they fail, then the new bank would compensate for the loss, and the supply of lending to the market would not suffer. The bankruptcy courts would sort out what the other financial companies don't pick clean by way of acquisitions. Letting nature take its course would bring us back to the Darwinian principle of the survival of the fittest.

If John Galt is among us, let us hope he does not wait for our economy to collapse before providing an answer to our problems, or else the "looters" will come up with a solution of their own.

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